Tennessee State School Bond Authority

For the Year Ended
June 30, 1999

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Edward Burr, CPA
Assistant Director

Teresa L. Hensley, CPA
Audit Manager

Rew Sloan
In-Charge Auditor

Kathy Gabriel
Amy Mallicote
Erick Rosa
Michael Wilbanks
Staff Auditors

Erica V. Smith, CPA
Technical Analyst

Amy Brack
Editor

March 15, 2000

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable John G. Morgan
Comptroller of the Treasury
Secretary of the Tennessee State School Bond Authority
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee State School Bond Authority for the year ended June 30, 1999. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

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State of Tennessee

Audit Highlights

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
Tennessee State School Bond Authority
For the Year Ended June 30, 1999

AUDIT OBJECTIVES

The objectives of the audit were to consider the authority's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

AUDIT FINDINGS

The audit report contains no findings.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 741-3697

Audit Report
Tennessee State School Bond Authority
For the Year Ended June 30, 1999

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For the Year Ended June 30, 1999

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee State School Bond Authority. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

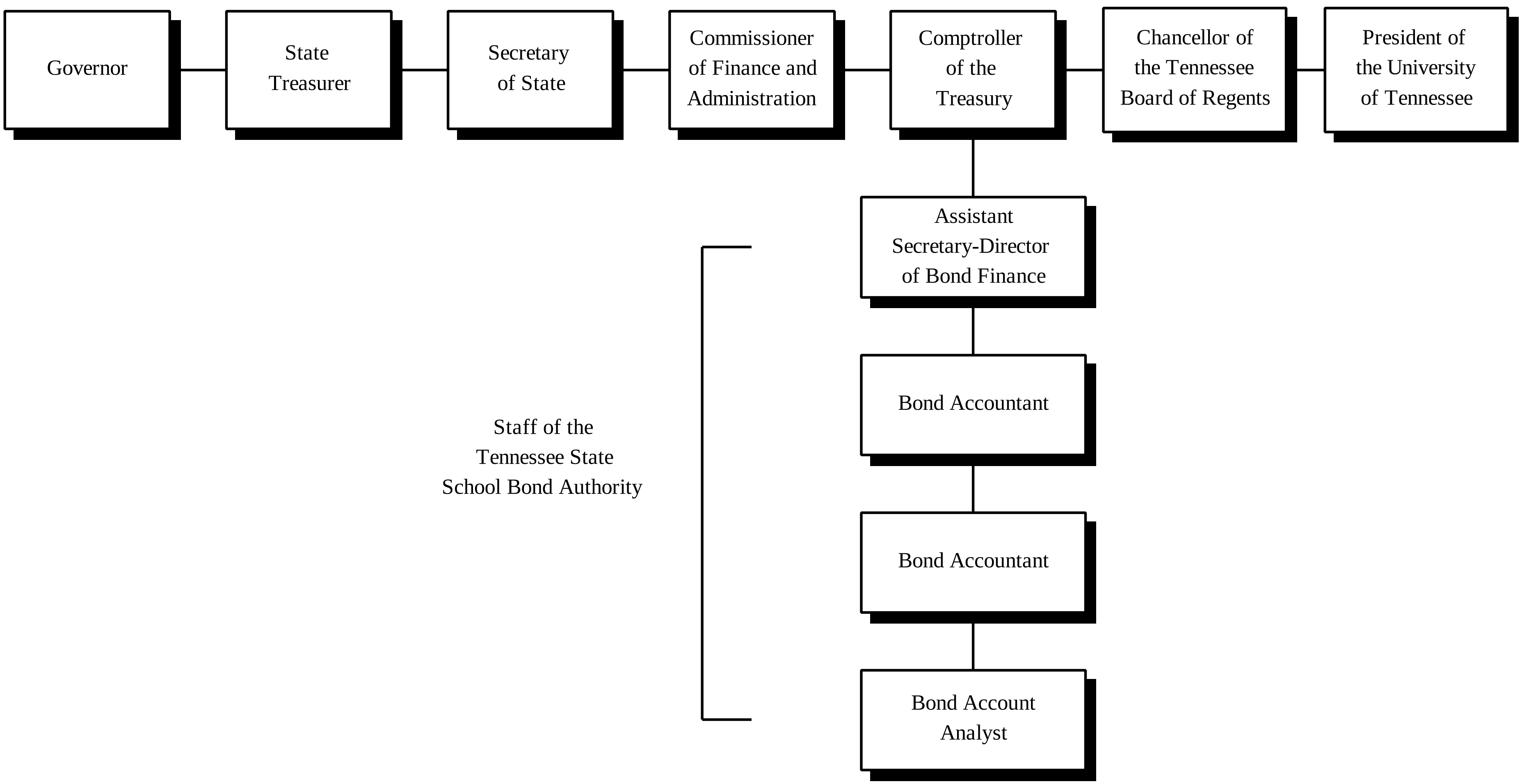
The Tennessee State School Bond Authority was established by the Tennessee State School Bond Authority Act, Chapter 256 of the Public Acts of 1965. As provided in this act, the authority is to act as a corporate governmental agency of the State of Tennessee for financing projects of the state's higher education institutions. The authority is empowered to issue negotiable bonds and notes as a means of providing funds for financing approved projects. These projects include buildings, equipment, structures, and improvements. In 1980, the legislature amended the original act to include, as a project, a program for student loans. The amount of funds provided should be sufficient to cover the actual project costs, as well as the authority's administrative expenses, including the cost of conducting the bond and note sales.

ORGANIZATION

The Tennessee State School Bond Authority consists of seven members: the Governor, the State Treasurer, the Secretary of State, the Commissioner of Finance and Administration, the Comptroller of the Treasury, the Chancellor of the Tennessee Board of Regents, and the President of the University of Tennessee. The Governor serves as chairman, and the Comptroller of the Treasury serves as secretary. The Director of the Division of Bond Finance serves as the assistant secretary; the division provides administrative and financial services to the Tennessee State School Bond Authority.

An organization chart for the authority is on the following page.

TENNESSEE STATE SCHOOL BOND AUTHORITY
ORGANIZATION CHART



AUDIT SCOPE

The audit was limited to the period July 1, 1998, through June 30, 1999, and was conducted in accordance with generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 1999, and for comparative purposes, the year ended June 30, 1998. The Tennessee State School Bond Authority has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

The audit covered allotment code 307.07 - Division of Bond Finance (Fund 32).

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the authority's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* it included tests of compliance with applicable federal laws and regulations and consideration of internal control. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee State School Bond Authority filed its report with the Department of Audit on October 28, 1999. A follow-up of all prior audit findings was conducted as part of the current audit.

The current audit disclosed that the Tennessee State School Bond Authority has corrected previous audit findings concerning inadequate accounting procedures and recordkeeping, cash reconciliations not properly performed, and significant discrepancies in the schedule of receivables and supporting documents.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee State School Bond Authority's financial statements for the year ended June 30, 1999, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted government auditing standards. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Tennessee State School Bond Authority's financial statements.

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

December 9, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of and for the year ended June 30, 1999, and have issued our report thereon dated December 9, 1999. We conducted our audit in accordance with generally accepted government auditing standards.

Compliance

As part of obtaining reasonable assurance about whether the authority's financial statements are free of material misstatement, we performed tests of the authority's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain matters involving the internal control over financial reporting, which we have reported to the authority's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/cj

Independent Auditor's Report

December 9, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying balance sheets of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of June 30, 1999, and June 30, 1998, and the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the authority's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated January 22, 1999, we qualified our opinion on the 1998 financial statements because insufficient audit evidence existed to support the authority's disclosures required by Governmental Accounting Standards Board (GASB) Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*. The authority's year 2000 disclosures are now reported as required supplementary information as permitted by GASB Technical Bulletin 99-1, *Disclosures about Year 2000 Issues—an amendment of Technical Bulletin 98-1*. Accordingly, our present opinion on the 1998 statements, as expressed herein, is different from our prior report on the 1998 financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee State School Bond Authority as of June 30, 1999, and June 30, 1998, and the results of its operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

The Year 2000 Disclosures on pages 22 and 23 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it. In addition, we do not provide assurance that the authority is or will become year 2000 compliant, that the authority's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the authority does business are or will become year 2000 compliant.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 9, 1999, on our consideration of the authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/cj

Exhibit A

TENNESSEE STATE SCHOOL BOND AUTHORITY
COMPARATIVE BALANCE SHEETS
JUNE 30, 1999, AND JUNE 30, 1998

(Expressed in Thousands)

	June 30, 1999	June 30, 1998
ASSETS		
Current assets:		
Cash (Note 2)	$ 24,067	$ 7,988
Cash with fiscal agent (Note 2)	137	2,282
Investments with fiscal agent (Note 2)	596	46
Loans receivable (Note 3)	19,332	21,077
Interest receivable (Note 3)	1,960	2,062
Due from other component units	368	555
Total current assets	46,460	34,010
Restricted assets (Notes 2 and 4):		
Crossover refunding investments	4,368	8,409
Debt service reserve	21,195	39,153
Total restricted assets	25,563	47,562
Other assets:		
Advances to other component units (Note 3)	438,010	340,172
Deferred charges	2,196	1,114
Total other assets	440,206	341,286
Total assets	$ 512,229	$ 422,858
LIABILITIES AND EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ -	$ 9
Warrants/wires payable	58	197
Due to other component units	5,655	1,509
Matured bonds and interest payable	-	1,333
Accrued interest payable	2,661	2,788
Commercial paper payable (Note 5)	162,050	91,750
Revenue bonds payable (Note 5)	19,332	21,077
Deferred revenue (Note 6)	5,720	456
Total current liabilities	195,476	119,119
Noncurrent liabilities:		
Net revenue bonds payable (Note 5)	310,230	297,619
Total liabilities	505,706	416,738
Equity:		
Retained earnings, unreserved	6,523	6,120
Total liabilities and equity	$ 512,229	$ 422,858

The notes to the financial statements are an integral part of this statement.

Exhibit B

TENNESSEE STATE SCHOOL BOND AUTHORITY
COMPARATIVE STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN RETAINED EARNINGS
FOR THE YEARS ENDED JUNE 30, 1999, AND JUNE 30, 1998

(Expressed in Thousands)

	Year Ended June 30, 1999	Year Ended June 30, 1998
OPERATING REVENUES		
Revenue from loans	$ 21,345	$ 18,120
Investment income		
Interest	1,926	3,057
Net increase in the fair value of investments	962	1,093
Total operating revenues	24,233	22,270
OPERATING EXPENSES		
Interest expense:		
Commercial paper	4,034	1,136
Revenue notes	-	893
Revenue bonds	18,641	19,060
Total interest expense	22,675	21,089
Administrative expense	353	466
Amortization of bond issuance costs	103	68
Total operating expenses	23,131	21,623
Operating income	1,102	647
EXTRAORDINARY ITEM		
Loss on bond refundings	699	-
Net income	403	647
Retained earnings, July 1	6,120	5,422
Cumulative effect of a change in accounting principle	-	51
Retained earnings, July 1, as restated	6,120	5,473
Retained earnings, June 30	$ 6,523	$ 6,120

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
COMPARATIVE STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 1999, AND JUNE 30, 1998

(Expressed in Thousands)

	Year Ended June 30, 1999	Year Ended June 30, 1998
Cash flows from operating activities:		
Operating income	$ 1,102	$ 647
Adjustments to reconcile operating income to net cash provided (used) by operating activities:		
Amortization of bond issuance costs	103	68
Investment income	(2,888)	(4,150)
Interest expense	22,675	21,089
Interest income from loans	(20,647)	(17,869)
Changes in assets and liabilities:		
(Increase) decrease in due from other component units	187	(259)
Increase (decrease) in accounts payable	(8)	(12)
Increase (decrease) in warrants/wires payable	(25)	83
Increase (decrease) in matured bonds and interest payable	(1,333)	509
Increase (decrease) in deferred revenue	329	408
Total adjustments	(1,607)	(133)
Net cash provided (used) by operating activities	(505)	514
Cash flows from noncapital financing activities:		
Proceeds from sale of bonds and notes	152,370	21,715
Proceeds from sale of commercial paper	117,600	91,750
Bond issuance costs paid	(764)	-
Retirement of debt	(3,958)	-
Refunding bond proceeds placed in escrow	(118,415)	-
Principal payments - bonds, notes, and commercial paper	(69,122)	(83,997)
Interest paid - bonds, notes, and commercial paper	(21,143)	(20,021)
Net cash provided by noncapital financing activities	56,568	9,447
Cash flows from investing activities:		
Purchases of investments	(50,888)	(78,362)
Proceeds from sales and maturities of investments	73,223	79,872
Interest received on investments	2,123	3,106
Loans issued	(104,765)	(56,144)
Collections of loan principal	22,125	24,613
Interest received on loans	16,053	14,644
Net cash used by investing activities	(42,129)	(12,271)
Net increase (decrease) in cash	13,934	(2,310)
Cash, July 1	10,270	12,580
Cash, June 30	$ 24,204	$ 10,270
Reconciliation of cash to the balance sheet:		
Cash	$ 24,067	$ 7,988
Cash with fiscal agent	137	2,282
Cash, June 30	$ 24,204	$ 10,270
Noncash financing activities:		
Accretion of capital appreciation bonds	$ 1,386	$ 1,672
Bond issuance costs	720	-
Total noncash financing activities	$ 2,106	$ 1,672

The notes to the financial statements are an integral part of this statement.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Tennessee State School Bond Authority (the "Authority") was created to provide a mechanism for financing capital projects for the state's higher education institutions. The Authority is a component unit of the State of Tennessee (the "state") and a separate legal entity. In accordance with the Governmental Accounting Standards Board's (GASB) Statement 14, the Authority is discretely presented in the *Tennessee Comprehensive Annual Financial Report* because the Authority's board consists of state officials and, therefore, the state has the ability to affect the day to day operations of the Authority.

Basis of Presentation

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the GASB. The Tennessee State School Bond Authority follows all applicable GASB pronouncements as well as applicable private sector pronouncements issued on or before November 30, 1989.

Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Investments

Investments are stated at fair value.

Amortized Amounts

a. Bond Issuance Costs. The Authority amortizes bond issuance costs using the straight-line method over the life of the bonds. Unamortized bond issuance costs are reported as deferred charges.

b. Bond Discounts, Premiums, and Deferred Amount on Refundings. The Authority amortizes bond discounts and premiums using the straight-line method over the life of the bonds. The deferred amount on refundings is also amortized using the straight-line method over the life of the bonds. Bonds payable are reported net of the applicable unamortized bond discount or premium and the unamortized deferred amount on refundings.

c. Accretion. The difference between the face amount of College Saver Bonds (capital appreciation bonds) and the public offering price is not treated as bond discount. Capital appreciation bonds are subject to redemption at prices which increase from the initial public offering price to the face amount. The carrying amount of these bonds is adjusted semi-annually to reflect the increased liability, with a corresponding charge to interest expense.

d. Deferred Revenue. When the Authority issues bonds to finance capital projects, the par amount of the bonds is adjusted by certain amounts (such as bond discount/premium, underwriters' fees, and other costs of issuance) in order to arrive at the amount of bond proceeds available for capital expenditures. These amounts, discussed above, are capitalized and amortized pursuant to generally accepted accounting principles. A similar situation arises when accounting for the loans to the higher education institutions. Because of the adjustments mentioned above (discount, costs of issuance, etc.), the principal amount of the loan differs from the actual amount of funds available for capital expenditures. Because the higher education institutions bear the cost of this difference, it is carried on the balance sheet as a deferred revenue and amortized over the life of the bonds.

NOTE 2. DEPOSITS AND INVESTMENTS

Under the general bond resolution of the Tennessee State School Bond Authority, the funds of the Authority can be invested in direct obligations of the United States, or obligations for which the principal and interest are guaranteed by the United States, or certain insured or collateralized accounts. Deposits and investments of the Authority meet the requirements of the general bond resolution.

Deposits

The Authority's deposits are held in a financial institution which participates in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 1999, the Authority had $136,907 on deposit with the fiscal agent. At June 30, 1998, the Authority had $2,281,840 on deposit with the fiscal agent.

The carrying amount of cash on deposit in the State Treasurer's pooled investment fund was $24,067,076 on June 30, 1999, and $7,988,228 on June 30, 1998.

Investments

Investments are categorized to indicate the level of custodial risk assumed by the Authority at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the Authority or its agent in the Authority's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the Authority's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the Authority's name.

Authority investments at June 30, 1999, are categorized below (expressed in thousands):

	Category 1	Category 2	Category 3
Federal Home Loan Bank Discount Notes	$21,791	$ --	$ --
U.S. Treasury Securities-State and Local Government Series	4,368	--	--
	$26,159	$ --	$ --

Authority investments at June 30, 1998, are categorized below (expressed in thousands):

	Category 1	Category 2	Category 3
U.S. Treasury Notes	$39,199	$ --	$ --
U.S. Treasury Securities-State and Local Government Series	8,409	--	--
	$47,608	$ --	$ --

NOTE 3. LOANS TO HIGHER EDUCATION INSTITUTIONS

The Authority and the Board of Trustees of the University of Tennessee and the Tennessee Board of Regents have entered into financing agreements, each originally dated May 1, 1967, and amended and restated as of September 17, 1996, under which the Board of Trustees or the Tennessee Board of Regents, as the case may be, has agreed to construct projects that the Authority has agreed to finance. Financing charges payable under the agreement must be sufficient to pay all principal and interest of the notes and bonds of the Authority as shall become due.

NOTE 4. RESTRICTED ASSETS

Crossover Refunding Investments

This account represents the proceeds of the 1996 Series D refunding bonds placed in an irrevocable trust with the fiscal agent for the redemption of the outstanding 1990 Series B Bonds maturing in 2004-2011.

Debt Service Reserve

The general bond resolution of the Authority requires that the principal of each bond issue include an amount equal to the maximum annual debt service requirements and that such amounts be placed in special trust accounts with the trustee; $21,194,955 is the sum of such amounts provided at June 30, 1999, and $39,153,042 at June 30, 1998.

NOTE 5. DEBT PAYABLE

Revenue Bonds

The Authority issues revenue bonds to finance capital projects for the state's higher education institutions. The bonds, as well as the notes of the Authority, are not general obligations of the State of Tennessee. They are secured by a pledge of the revenues from the facilities for which financing has been provided through the sale of the Authority's bonds and notes and by other revenues and resources available to the Authority and to the higher education institutions.

Bonds payable, net of unamortized discount, premium, and deferred amounts at June 30, 1999, and June 30, 1998, are as follows (expressed in thousands):

	June 30, 1999	June 30, 1998
Bonds Payable:		
1967 Series A at an interest rate of 4.1% maturing to 2007	$ 9,420	$ 11,015
1972 Refunding issue at interest rates from 5.25% to 5.40% maturing to 2005	-	18,340
1976 Series B at an interest rate of 3.0% maturing to 2011	2,506	2,715
1977 Series A at interest rates from 5.40% to 5.75% maturing to 2006	-	1,780
1977 Refunding Bonds at interest rates from 5.4% to 5.8% maturing to 2011	-	28,820
1985 Series B at interest rates from 5.9% to 7.0% maturing in 2015	-	26,385
1987 Refunding Series A at an interest rate of 4.0% maturing in 2012	5,250	5,250
1989 Current Interest Bonds at an interest rate of 7.0% maturing in 2020 and 1989 College Saver Bonds with yields from 6.65% to 6.90% maturing to 2010 (at accreted value)	21,472	27,150

	June 30, 1999	June 30, 1998
1990 Series A (Taxable) and Series B at interest rates from 6.7% to 9.0% maturing to 2011	5,915	6,195
1992 Series A at interest rates from 5.625% to 6.25% maturing to 2022	-	40,775
1996 Series A at interest rates from 5.0% to 6.0% maturing to 2026	92,625	96,290
1996 Refunding Series B at interest rates from 5.0% to 6.0% maturing to 2011	45,510	48,535
1996 Refunding Series C at interest rates from 5.375% to 6.0% maturing to 2020	4,045	4,045
1996 Refunding Series D at interest rates from 5.0% to 5.5% maturing to 2011	4,400	4,400
1998 Series A at interest rates from 4.3% to 5.0% maturing to 2028	54,865	-
1998 Series B (Taxable) at interest rates from 5.8% to 6.7% maturing to 2028	15,460	-
1998 Refunding Series C at interest rates from 3.65% to 5.00% maturing to 2014	41,285	-
1998 Refunding Series D at interest rates from 3.65% to 4.85% maturing to 2021	31,125	-
Total Par Amount of Bonds Payable	333,878	321,695
Plus Unamortized Premium/Less Unamortized Discount	425	(771)
Bonds Payable Net of Unamortized Premium/Discount	334,303	320,924
Less: Deferred Amount on Refundings	(4,741)	(2,228)
Net Bonds Payable	$ 329,562	$ 318,696

Under the terms of the 1985 Series B Tax-Exempt Exchangeable Securities, on semi-annual payment dates, each holder of the 7% securities may exercise a one-time election to convert to a variable interest rate, not to exceed 10%, as established by an independent municipal securities evaluation service pursuant to a prescribed formula. At June 30, 1998, $16.95 million of the bonds were held at an interest rate of 7.0% and $9.435 million were held at a variable interest rate. The 1985 Series B Tax-Exempt Exchangeable Securities were defeased by the 1998 Series C Refunding Bonds as of October 1, 1998.

Debt service requirements to maturity of the revenue bonds payable at June 30, 1999, are as follows:

For the Year(s) Ending June 30	Principal	Interest	Total
2000	$ 18,004	$ 17,466	$ 35,470
2001	18,429	16,603	35,032
2002	18,530	15,879	34,409
2003	17,814	15,119	32,933
2004	18,850	14,367	33,217
2005-2028	232,569	133,849	366,418
Total	$324,196	$213,283	$537,479

The above principal for revenue bonds is less than that presented on the accompanying financial statements by $5.366 million. Of this amount, $10.107 million represents accretion to date on the unmatured portion of the 1989 College Saver Bonds. This accretion has been reported as bond principal in the accompanying financial statements. In the debt service schedule above, however, it has been reported as interest in the years (2000-2010) in which the bonds mature. The $5.366 million also includes $4.741 million, representing the deferred amount on bond refundings. This amount is presented as a deduction from bonds payable in the accompanying financial statements but is not reflected in the debt service schedule above.

On April 27, 1998, the Authority approved the Higher Education Facilities Second Program General Bond Resolution. As a result of the approval of this resolution, the Authority's bonds were upgraded to a rating of Aa_2 by Moody's Investors Service and AA+ by Standard & Poor's Rating Group.

On October 1, 1998, the Authority issued four series of bonds under the Second Program Bond Resolution.

The 1998 Series A Bonds were issued in the amount of $54,865,000. The bond proceeds provided resources to redeem $43,700,000 of the Authority's tax-exempt Commercial Paper, to pay $10,480,157 in construction costs for certain projects, to cover the costs of issuance of the bonds, and to purchase a surety policy.

The 1998 Series B Bonds (Federally Taxable) were issued in the amount of $15,460,000. The bond proceeds provided resources to redeem $2,200,000 of the Authority's taxable Commercial Paper, to pay $12,078,934 in construction costs for certain projects, to place $958,755 into a capitalized interest account, to cover the costs of issuance of the bonds, and to purchase a surety policy.

Current, Advance, and Crossover Refundings

The 1998 Series C Bonds were issued in the amount of $48,735,000 as part of a current refunding. The bond proceeds, along with an equity contribution of $12,958,629 and proceeds from the issuance of $15,000,000 in taxable Commercial Paper, provided resources to purchase securities that were placed in an irrevocable trust to redeem $18,340,000 of outstanding 1972 Series A bonds, $1,780,000 of outstanding 1977 Series A bonds, $28,820,000 of outstanding 1977 Refunding Bonds, and $26,385,000 of outstanding 1985 Series B bonds; to pay five months of interest on the refunded bonds; to cover the costs of issuance of the bonds; and to purchase a surety policy. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $847,146. Of this amount, $274,486 is recognized on the accompanying financial statements as an extraordinary loss. The remaining $572,660 is reported as a deduction from bonds payable and is being charged to operations through the year 2014 using the straight-line method. The refunding resulted in a reduction of total debt service payments of $18,561,874 over the next 15 years and an economic gain (difference between the present values of the old and new debt service payments) of $6,380,441.

The 1998 Series D Bonds in the amount of $33,540,000 were issued as part of an advance refunding of $40,775,000 of outstanding 1992 Series A bond principal. The bond proceeds, along with an equity contribution of $4,378,018 and proceeds from the issuance of $6,800,000 in taxable Commercial Paper, provided resources to purchase securities that were placed in an irrevocable trust to pay principal and interest on the 1992 Series A bonds until May 1, 2002, and on May 1, 2002, to redeem the remaining 1992 Series A bond principal outstanding; to cover the costs of issuance of the bonds; and to purchase a surety policy. The irrevocable trust is invested in United States of America Treasury Notes maturing on certain dates and in various amounts through May 1, 2002. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $2,533,507. Of this amount, $425,012 is recognized on the accompanying financial statements as an extraordinary loss. The remaining $2,108,495 is reported as a deduction from bonds payable and is being charged to operations through the year 2021 using the straight-line method. The refunding resulted in a reduction of total debt service payments of $11,203,053 over the next 22 years and an economic gain (difference between the present values of the old and new debt service payments) of $2,547,920.

The Authority's issuance of $21,800,000 of taxable Commercial Paper in conjunction with these refundings was executed in preparation for the conversion of the University of Tennessee Hospital to a 501(c)(3) corporation. Various hospital-related projects had previously been financed through the refunded bonds, and the Commercial Paper was used to refund the portion of the outstanding bonds attributable to those projects.

On May 1, 1999, the Authority liquidated $3,957,600 of crossover refunding investments in order to call $3,880,000 of 1989 Current Interest Bonds. Pursuant to the requirements of the bond indenture, the Authority was required to pay a call premium of $77,600. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the refunded debt of $103,152, which is reported as a deduction from bonds payable and is being charged to operations through the year 2020 using the straight-line method.

Commercial Paper Program

The Tennessee State School Bond Authority issues short-term debt to finance certain capital projects for the State of Tennessee's higher education institutions. The Authority approved an increase in the maximum amount authorized from $150 million to $200 million on January 7, 1999. Commercial Paper may be issued as tax-exempt or as taxable. At the Program's inception, Commercial Paper refinanced certain outstanding bond anticipation note indebtedness that the Authority had previously issued to finance capital projects. The Commercial Paper dealer is J.P. Morgan & Co. At June 30, 1999, the Authority had issued and outstanding $96,600,000 of tax-exempt and $65,450,000 of federally taxable Commercial Paper. At June 30, 1998, the Authority had issued and outstanding $87,500,000 of tax-exempt and $4,250,000 of federally taxable Commercial Paper.

Commercial Paper is a special obligation of the Authority. Commercial Paper principal and interest may be paid from: (i) the proceeds of draws on the Liquidity Facility, (ii) available revenues, (iii) the moneys and securities (if any) on deposit in the Commercial Paper and reimbursement account and in the Debt Service Fund, (iv) the moneys and securities (if any) on deposit in the Project Construction Account for such projects, and (v) the proceeds of bonds, notes, or other evidences of indebtedness to the extent set aside to make such payments.

The maturity of the Commercial Paper may not exceed 270 days and the maximum interest rate may not exceed 12%. Upon maturity, the Paper is remarketed by the commercial paper dealer, redeemed, or extinguished with long-term debt. The Commercial Paper bears interest at a variable rate that is paid upon maturity. The higher education institutions contribute funds to the Interest Rate Reserve Fund. The principal of the Interest Rate Reserve Fund is credited back to the institution as Commercial Paper is redeemed. The Interest Rate Reserve Fund consisted of $784,915 at June 30, 1999, and $408,135 at June 30, 1998.

The Commercial Paper liquidity provider, under an Advance Agreement, is *Westdeutsche Landesbank Girozentrale*, New York branch. The total available commitment is $182,700,000. The obligation of *Westdeutsche Landesbank Girozentrale* is to purchase unremarketed Commercial Paper.

Retired Notes Program

Prior to the inception of the Commercial Paper Program, interim and short-term financing for various projects was secured through the Tennessee State School Bond Authority in a Bond Anticipation Notes (BANs) Program. The program was established February 24, 1993, with Prudential Securities, Incorporated, as the underwriter and remarketing agent, to fund projects under construction. The notes bore interest at a variable rate which was reset weekly by Prudential Securities, Incorporated. Interest on the notes was paid monthly. Under the BANs Program, the final maturity of the notes was March 1, 1998; however, the notes were retired December 1, 1997, and redeemed with proceeds of the Commercial Paper Program.

NOTE 6. DEFERRED REVENUE

As a result of the issuance of the 1998 Series A bonds, the Authority recorded deferred revenue of $684,843, which will be amortized on a straight-line basis through the year 2028.

As a result of the issuance of the 1998 Series B bonds, the Authority recorded deferred revenue of $222,311, which will be amortized on a straight-line basis through the year 2028.

As a result of the issuance of the 1998 Series C bonds and the current refunding of the 1972 Series A, 1977 Series A, 1977 Refunding, and 1985 Series B bonds, the Authority recorded deferred revenue of $304,450, which will be amortized on a straight-line basis through the year 2014.

As a result of the issuance of the 1998 Series D bonds and the advance refunding of the 1992 Series A bonds, the Authority recorded deferred revenue of $3,163,437, which will be amortized on a straight-line basis through the year 2021.

As a result of the crossover refunding of the 1989 Current Interest Bonds, the Authority recorded deferred revenue of $165,000, which will be amortized on a straight-line basis through the year 2020.

NOTE 7. ACCOUNTING CHANGE

During the year ended June 30, 1998, the Authority implemented GASB statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which requires reporting certain investments at fair value. Changes in the fair value of investments (inclusive of both realized and unrealized gains and losses) are recognized as revenue in the operating statement.

The cumulative effect of this change in accounting principle is reported in the accompanying financial statements as a restatement of retained earnings as of July 1, 1997. Not all information was available to restate prior periods to conform to this accounting change.

NOTE 8. SUBSEQUENT EVENTS

On July 29, 1999, a change in the University of Tennessee's reporting entity made it necessary for the Authority to defease debt that had been issued on behalf of the University Medical Center. This debt consisted of $96,400,000 in Commercial Paper and $52,850,000 in bonds.

On November 30, 1999, the Authority had outstanding $80,800,000 in tax-exempt and $4,300,000 in federally taxable Commercial Paper. Between June 30, 1999, and November 30, 1999, the Authority has issued $19,450,000 in Commercial Paper to pay construction expenditures.

On November 30, 1999, the Authority issued Qualified Zone Academy Bonds (QZAB) to finance loans to qualifying K-12 schools in the amount of $13,290,000. The bonds are part of a federal government program in which a federal tax credit is given to investors in lieu of interest. The bonds were issued under the provisions of the Tennessee State School Bond Authority's Qualified Zone Academy First Program Resolution and will mature on November 1, 2011.

The "Year 2000 Issue" ("Y2K") arises because most computer software programs allocate two digits to the data field for "year" on the assumption that the first two digits will be "19." Such programs will thus interpret the year 2000 as the year 1900, the year 2001 as 1901, etc. Absent reprogramming, Y2K affects both computer hardware (i.e., the embedded logic of computer chips) and computer software, and could impact both the ability to enter data into the computer programs and the ability of such programs to correctly process data. Y2K affects the computer applications and other equipment of the Authority and its vendors, investment providers, and bond trustees.

The state has assessed the impact of Y2K on its computer applications. The state has completed its assessment and has determined that certain computer applications are mission-critical, certain are critical, and certain are supportive. Mission-critical computer applications are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the state from fulfilling its mission. Critical computer applications are those for which there are manual alternatives, but the state would unlikely be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer applications are those for which there are manual alternatives and the state expects to be able to perform such functions manually, if necessary.

The Authority has identified two mission-critical applications. The Authority relies principally upon the State of Tennessee Accounting and Reporting System (STARS) administered by the state's Department of Finance and Administration and upon the Cash Management System administered by Treasury. The Authority's Y2K initiatives had not resulted in the commitment of significant financial resources as of the end of the Authority's reporting period.

As of June 30, 1999, STARS and the Treasury Cash Management System had completed the validation and testing stage. In this context, validation and testing refers to the development of test data and test scripts, the running of test scripts, the review of test results, and the correction of any anomalies detected.

The state is continuing testing of its computer applications and expects the cost to be $15.5 million. The state's mainframe system provides the supporting computer system infrastructure upon which the state's application systems reside and are processed. The state's mainframe and all systems' software have completed the validation and testing stage. The state is in the process of assessing and remediating the Y2K effect on other equipment.

The state is not presently aware of any noncompliance by its yet untested mission-critical and critical computer applications and other equipment or of any costs to achieve Y2K compliance that will have a material negative impact on the state's operations or financial status; however, the state can give no assurance that circumstances will not change. The state has developed contingency plans for all mission-critical and critical functions.

The state's efforts to ensure Y2K compliance of its computer applications, mainframe and systems' software, desktop applications, and other equipment are not a guarantee that systems and equipment will be Y2K compliant.

The state is soliciting information from other organizations whose Y2K compliance could affect the state regarding the status of their assessment, testing, and remediation of their computer applications and other equipment. Of the organizations that have responded to date, all expect to achieve compliance in a manner that will not have a material negative effect on the state's operations or financial status, although no assurances can be given that circumstances will not change. The state does not have full and complete information from these organizations regarding the status of implementing Y2K compliance. Any failure by some or all of these organizations to be in Y2K compliance may have a material negative impact on the state's operations or financial status.